Overview

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Discipline plays an important but sometimes ambiguous role in the financial world. It is helpful to realize that there are two sorts of discipline in finance, that of the government and the marketplace. One of our speakers highlighted the dilemma of discipline by asking: "What would you have done about the Lockheed, Chrysler, Financial Corporation of America, and Continental Illinois crises?"

It is useful to differentiate between the types of discipline because phrases like government discipline can be somewhat misleading in the real financial world, even though these phrases may have specific meanings, both conceptually and philosophically.

First, there is a difference between the role played by the business community—broadly defined as commerce—and the special role played by the banking community. Some differentiation has to be made between the two when one talks about discipline in a final sense.

Second, there is the question of depositor and investor discipline. While, theoretically, "depositor discipline" sounds reassuring, the way it works in practice in a financial world of some 14,500-plus commercial banks is more problematic. Public information about the top 100 to 150 banks and bank holding companies is fairly broad and deep, but for the most part, the information available to depositors at smaller institutions is modest at best. Enforcing depositor discipline by making the depositor lose more than an insured amount is not a practical solution.

Investor discipline is a practical solution for institutions about which there is sufficient information for investors to make critical judgments. Many publicly rated banks are followed by bank analysts and the like. But the great fault of the smaller individual banking institutions in the United States is that investors and depositors do not have access to that sort of detailed information. In a smaller community, the investors with access to that information tend to be members of a close-knit group. Hence, the concept of investor discipline does not work with the same facility as it would in larger institutions.

The question of discipline forces us to consider the purpose of deposit insurance. Is its purpose to protect the bank? To protect the depositor? To protect the financial system? Or some combination of the three? While none of these clarifications has taken place, you have in the meantime a regulatory apparatus that, in my opinion, is doing the best job possible. I think Continental Illinois represents an evolutionary step from First Pennsylvania, in that our regulators came up with what might be called the supervisory "neutron bomb": the shareholders are destroyed, the managements are destroyed, the directors are destroyed, but the institutions are able to continue functioning, thereby preventing systemic collapse. This is an area needing much more attention.

Governments have a number of indirect means of encouraging discipline. Governments exercise control, if you will, through tax laws, accounting standards, and a variety of other laws that affect the way banks handle, say, the lesser developed country debt problem. As Peter Cooke has pointed out, there are great differences between nations' underlying rules that make direct governmental regulation difficult to achieve. So there are forms of direct discipline from the supervisory framework. Government may exercise discipline indirectly through tax laws.

The question of discipline leads us straight to the altered nature of the entire financial services industry. The forces that have been changing the international financial system—of which the American system is an integral part—are fundamental. Among them are the institutionalization of savings, technology, deregulation, and of course, the history of inflation and volatility in markets, interest rates, and exchange rates. All these forces, none of which has alone been preeminent, have together shaped a new international financial system, of which we are part and through which discipline will be exercised.

Let me briefly expand on just a few of those forces. The institutionalization of savings occurs as the management of savings shifts from the individual to the institution. The increasing choice of sophisticated managers of savings to deal through counterparties rather than through agencies is forcing change on the traditional financial intermediary system. Issuers look to the intermediaries to bid, rather than to act as agents in a traditional syndicate form. This change has driven the intermediary system into the search for increased amounts of capital to service the needs of the issuers and takers of securities. And with the advent of the Big Bang, that search has caused consolidation in the financial services industry, both here and in London, for example.

The effects of technology have been phenomenally important in the financial system of the world. Mortgage-backed securities, for example, could not exist without data processing. (It is worth noting that trading in mortgage-backed securities in 1985 was greater than all of the trading on all of the stock exchanges of the world.) By improving communications, technology has created enormous velocity and volatility in the market.

Let me cite just one example of our transformed world. Currency swaps makes it possible to borrow in any currency and then switch, or swap, to the currency one needs. The issuer's only concern is terms, meaning the lowest possible net cost. Discrete markets, then, begin to disappear. You create a global debt market different from the domestic debt market. Access to the global debt market is for the largest, most creditworthy issuers.

This transformation creates, in turn, a whole host of potential problems in terms of how markets operate during periods of stress or crisis—periods with which, thankfully, we have had little experience. In this process, you have the blurring of distinctions between financial institutions that Henry Kaufman and others have talked about in the last few days. We do not understand what those distinctions or their blurring will mean in times of crisis, or economic downturn. Most of these trends have developed in the last few years, a time of relatively good financial and economic conditions worldwide.

One result of all this change has been volatility in markets. The question Kaufman and others raise is, "What is happening to the guardian of credit, and what are the end results of securitization?" What happens to the quality of banking companies as they continue to reduce or sell, through securitization, their better assets—that is, sell what they can sell to earn a profit?

Not many banking organizations will securitize those assets which cause them to take a loss. Increased leverage results in the system because of the unprecedented availability of ways to involve different parties. There are those who argue, and I am inclined to agree with them, that the interest rate swap is really a form of credit bootstrapping. In the long run, all this leads to a weakening of the commercial banking system. The flow of prime-quality business out of commercial banks into the capital markets drives commercial banks to two courses of action. One way is to expand loans to smaller, lower quality companies. The other—the preferred route most major banks have taken—is to recapture the business they have lost by becoming capital markets participants themselves. The commercial paper market is an example of that course.

The end result is that discipline for the debt that has been created is probably going to be exercised in new, not totally familiar ways. What I am putting forth is the concept that we are in the process of seeing **a** revolution in the financial services industry.

For the most part, the supervisory authorities have neither the power nor the responsibility to view the situation as a whole. We need, both internationally and certainly in the United States, a redefinition of the financial system in terms of how it is to function, and who is to oversee what. That also means a redefinition of **the** supervisory structure in the United States, an idea I have supported since 1975, when I was superintendent of banks for the state of New York.

What is the best way of handling the mountain of debt, and what happens when the due day comes? What would be the best structure for the financial institutions that own or service the debt? Answering these questions should, I think, be considered foremost among the challenges facing banking in the years ahead.